

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP  
ON INTERNATIONAL INVESTMENT STATISTICS**

**BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTG)**

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**ISSUE PAPER 21**

**INCOME ON SECURITIES LENDING AND REVERSIBLE GOLD TRANSACTIONS**

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**October 2004**

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<sup>1</sup> The views expressed in this Paper are those of the author and do not necessarily represent those of the European Central Bank.

1. **Securities lending (borrowing)** consists of the delivery of securities for a given time period. Usually the borrowers (e.g. brokers) subsequently on-sell the securities outright to other clients. The ability of the borrower to on-sell the securities reflects that legal ownership is transferred to the borrower, while the economic risks and benefits of ownership remain with the original owner. In return, the “lender” receives a fee from the “borrower” for the use of the security.

2. **Gold loans** consist of the delivery of gold for a given time period. As in the previous case, legal ownership of the gold is transferred (the temporary borrower may on-sell the gold to a third party), but the risks and benefits of changes in the gold price remain with the lender. Gold borrowers (usually market dealers/brokers) often use these transactions to cover their sales to third parties in periods of (temporary) gold shortage. A comparable fee is paid to the original owner for the use of the gold.

3. In both types of transactions, the fee is justified by the transfer of the use of the financial instrument/gold from the original owner to the borrower. No exchange of cash takes place. Occasionally, some provision of collateral to the lender may guarantee that, when the transaction matures, the borrower will return the financial instrument to its original owner plus a fee previously agreed.<sup>2</sup> The amount of the fee is determined by the value of the underlying asset and the duration of the reversible transaction.

4. The difficulties associated with the treatment of the fee resulting from securities lending and reversible gold transactions were tackled in the framework of investigations concerning the treatment of repo-type transactions by a Technical Group on Reverse Transactions (TG-RT) mandated by the IMF BOP Committee. No clear-cut recommendation could be submitted by the TG-RT on this specific issue.

#### **I. Current international standards for the statistical treatment of the issue**

5. Neither the *Balance of Payments Manual, fifth edition (BPM5)* nor the *1993 System of National Accounts (1993 SNA)* explicitly tackle the issue nor provide any applicable recommendation.

#### **II. Concerns/shortcomings of the current treatment**

6. As stated before, international statistical standards do not provide any guidance for the statistical treatment of this issue. The lack of guidance may pave the way for heterogeneous treatments across countries/reporting economies.

#### **III. Possible alternative treatments**

7. The TG-TR considered two alternative treatments for the fee associated with securities lending and gold loans/deposits, namely as property (investment) income or as (financial) services.

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<sup>2</sup> Should cash be provided as collateral, both securities lending and gold loans are normally treated as repo-type operations in statistics.

### Treatment as investment income

8. According to paragraph 272 of the BPM5, “*Investment income (property income in the SNA) covers income derived from a resident entity’s ownership of foreign financial assets. (...) Interest is payable in accordance with a binding agreement between the creditor and the debtor*”.<sup>3</sup>
9. The TG-TR considered that *property (investment) income* represents a return from the issuer/borrower to the holder/lender for the right to use a non-produced (financial) asset; in *securities lending/borrowing* a non-produced asset (the security) is made available to the borrower, which pays the fee in return for the right to *use* the financial asset. These arguments were interpreted by the TG-RT as supportive to the treatment as property (investment) income.
10. However, the TG-TR also recognised that, should the treatment as income be the preferred one, determining the type of income would not be straight forward. Actually such “income” would have little to do with the underlying financial instrument. For example, in the event of equity securities lending, the fee associated with the transaction can hardly be treated as a dividend (only applicable to the original *issuer* of the equity). Even for debt securities, the treatment as income would be hazardous, since it cannot be classified together with the income accrued by the original holder (and payable by the issuer).
11. Accordingly, the TG-TR concluded that, should the treatment as income be selected, it would require the creation of a new income category, in the “(primary) income account”. However, the annotated outline on the revision to the fifth edition of *BPM5* is proposing to structure the primary income account so that income items are explicitly linked to their associated asset on which the income is receivable/payable. “Other income” may be inappropriate as that would normally be expected to be linked to “other investment”. If a separate income category for income to cover securities lending were to be created for the fee receivable/payable on securities lending, a different asset item may also be necessary.
12. Paragraph 4.41 of the European System of Accounts (ESA95) reads: “*Property income (D.4) is the income receivable by the owner of a **financial asset** or a tangible non-produced asset **in return for providing funds to**, or putting the tangible non-produced asset at the disposal of, another institutional unit.*”

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<sup>3</sup> Further extracts from BPM5 paragraph 272: “(...) *The most common types of investment income are income on equity (dividends) and income on debt (interest). Dividends, including stock dividends, are the distributed earnings allocated to shares and other forms of participation in the equity of incorporated private enterprises, cooperatives, and public corporations. Dividends represent income that is payable without a binding agreement between the creditor and the debtor. Among other types of income on equity are (i) earnings of branches and other unincorporated direct investment enterprises and (ii) direct investors’ shares of earnings of incorporated direct investment enterprises. (The latter type of earnings, which are not formally distributed, are earnings other than dividends.) Shares of reinvested earnings attributed to direct investors are proportionate to the participation of the direct investors in the equity of the enterprise. Also, in principle, income is imputed to households from net equity in life insurance reserves and pension funds and included indistinguishably under other investment. Interest, including discounts in lieu of interest, comprises income on loans and debt securities (i.e., bank deposits, bills, bonds, notes, and trade advances). Net interest flows arising from interest rate swaps also are included. (See paragraph 406.)*”

13. Following this guidance, the treatment as interest (property income) seems to require the provision of funds from the lender to the borrower. However, such provision of funds do not take place in the case of either securities lending or gold loans/deposits. Actually no transaction is recorded in the financial account, nor any outstanding position is recorded in the international investment position.

14. One additional difficulty of the treatment as property income would be the need to recognise an independent financial entry in the financial account. Income does not accrue on the financial instrument exchanged (i.e. on any newly created obligation of the issuer vis-à-vis the temporary holder of the security), but rather on the use of the instrument. Should such a fee be added to the value of the underlying instrument (i.e. either securities or gold) while applying the accruals principle, the final result would exceed the true (market) value of the instrument.

15. For all these reasons, the implementation of this solution (treatment as investment income) would require the previous recording of a transaction in the financial account. This requirement would not conform to current practices in statistics.

16. For gold loans, the TF-RT discussed whether gold can be considered as a financial asset, a commodity, or a service. Gold is unique in the *1993 SNA* and *BPM5*, in that it can be either a financial asset (monetary gold is included in *reserve assets*) or a commodity (all other uses), depending on which institutional unit holds it and the use to which it is being put. If a gold loan is undertaken so that the ultimate user (for whom the financial intermediary borrows it, in the first place) takes delivery of it as commodity gold, treating the fee payable/receivable as property income is inappropriate as the commodity is a produced asset and produced assets do not earn property (investment) income.

#### Treatment as financial service

17. Paragraph 258 of the *BPM5* defines financial services in the following manner: “*Financial services covers financial intermediary and auxiliary services (except those of insurance enterprises and pension funds) conducted between residents and non-residents.(...)*”<sup>4</sup>

18. The TG-TR considered that, for the fee to be eligible for consideration as a financial service, some elements of securities lending should qualify to be considered as productive. Following this line of reasoning, the TG-TR intended to find out which productive activity could be assimilated to securities lending. The closest productive activity it found was *intermediation*, though the TG-TR finally recognised securities lending (i.e. the temporary cession of ownership on securities) did not belong in this productive activity.

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<sup>4</sup> Further extracts from *BPM5* paragraph 258: “(...) Included are intermediary service fees, such as those associated with letters of credit, bankers’ acceptances, lines of credit, financial leasing, and foreign exchange transactions. (For the latter, the spread between the midpoint rate and the buying or selling rate is the service charge.) Also included are commissions and other fees related to transactions in securities—brokerage, placements of issues, underwritings, redemptions, and arrangements of swaps, options, and other hedging instruments; commissions of commodity futures traders; and services related to asset management, financial market operational and regulatory services, security custody services, etc

19. However, the TG-TR also recognised that the non-existence of an adequate description of a productive activity in which securities lending could be encompassed does not necessarily preclude it from being treated as a service. The report of the TG-TR to the BOPCOM suggested some parallel justifications which could be used to justify the treatment as financial services. For example, securities lending could be assimilated to market making (offers the borrower a facility different from the alternative of purchasing the security).

20. In the case of gold loans/deposits, the use of a produced asset in the *1993 SNA* is treated as a service. However, although the underlying nature of a gold loan is the same as securities lending, and both were deemed to be productive, the production from gold lending would be different from that from securities lending: it would be a service for the use of a produced asset, not the provision of liquidity to a financial market.

21. The TG-RT considered also a third blended possibility whereby the fee would be treated as a financial service if the “lender” happened to be a financial intermediary, and as property (investment) income in all other cases. No clear solution to the problems outlined for the treatment as investment income was envisaged. In the end, the TG-RT could not come up with any satisfactory recommendation.

22. All in all, it seems the TGRT had good arguments to reject the treatment of these fees as investment income. It is not as clear why the treatment as financial services was rejected, since no fundamental problem seems to derive from the text addressed to BOPCOM.

#### **IV. Points for discussion**

*(1) What are the views of BOPTEG members concerning the three alternatives considered by the TG-RT for the treatment of the fees associated to securities lending, namely:*

- (i) Treatment as investment (property) income;*
- (ii) Treatment as financial service;*
- (iii) Blended approach whereby it would be treated as financial services if the “lender” were a financial intermediary, and as investment (property) income in all other cases.*

*(2) If securities lending fees are treated as investment (property) income, should they be classified as:*

- (i) interest or dividends, depending on the nature of the instrument provided by the fee recipient?*
- (ii) interest in all cases, regardless of the nature of the instrument provided by the fee recipient?*
- (iii) securities lending fees as a new income category?*
- (iv) some other treatment?*

*Note: Amounts payable on gold loans will be dealt with under the nonmonetary gold heading.*

## References

ECB, *The Statistical Treatment of Income Accruing on Securities Lending and Reversible Gold Transactions*, (document accompanying an official consultation letter addressed to the IMF Statistical Department in September 2000)

Technical Group on Reverse Transactions: Progress report to the 2003 meeting of the IMF Bop Committee (BOPCOM 2003/12) (<http://www.imf.org/external/pubs/ft/bop/2003/03-12.pdf>)